RS650-2

JAPAN · ECONOMIC · INSTITUTE

JEI REPORT

A Two-Part Report: A and B

NO. 8A February 23, 1990

FY 1990 OUTLOOK FOR THE JAPANESE ECONOMY

Summary

More than three years after the Japanese economy touched bottom in late 1986, its forward progress seems unstoppable. For fiscal 1989, which ends March 31, price-adjusted gross national product is nearly certain to grow more than 4 percent and perhaps as much as 5 percent. Most Japanese analysts expect growth to be almost as high in fiscal 1990, absent any special factors. These forecasts, of course, are based on assumptions that easily could prove incorrect. In many cases alternative scenarios would imply a higher rate of growth than currently expected.

Whatever happens to the Japanese economy, Washington will be playing close attention. On Capitol Hill as well as Wall Street and Main Street, Americans have a new appreciation -- and sometimes an exaggerated view -- of how the performance of the Japanese economy affects them. As the expansion matures, the Bank of Japan may feel compelled to fine-tune Japanese policy in ways that could be interpreted in some quarters as harmful to the U.S. economy. However, the impact would be small, with both benefits and costs to the U.S. economy.

Japan's Economy in FY 1989

Economic debate in Japan was preoccupied with two issues as 1989 dawned. The first focused on the effect of tax restructuring. A mixture of tax cuts and increases were implemented in the early part of 1989, with the new 3 percent consumption tax scheduled for collection starting April 1. The second issue centered on the persistent trade imbalance with the United States and the rest

of the world. While the surplus had narrowed marginally in 1988, it remained at a stubbornly high level despite the appreciation of the yen since 1985. The yen seemed to have reached a plateau in the range of Y120-Y130 to the dollar. Together, these factors suggested to many Japanese and foreign analysts that Japan would be lucky if the surplus did not begin expanding again.

Both the tax reform and the external imbalance seemed to have the potential to short-circuit Japan's economic expansion, which then was entering its second full year. Some analysts feared the new tax could create a ratchet effect on prices. They theorized that as the prices of affected goods rose to reflect the 3 percent consumption tax, merchants might take the opportunity to raise their own margins as well. Wage demands would then escalate, threatening Japan's hard-earned overall price and wage stability. In the view of Japanese analysts -- in contrast to most American experts who discount the effect of inflation on real purchases -- the resultant price increases would make consumers wary about buying, pushing the economy into a downturn.

While the effect of the tax measures was immediate, the threat posed by Japan's persistent current account surplus was more long term. In the short run Japanese firms benefited from buoyant demand in the United States and elsewhere. Over a period of years, however, Japanese experts feared that protectionist forces, especially in Japan's largest overseas market, the United States, would seize on Japan's trade figures as a rationale to restrict trade. Their apprehensions were heightened with the passage of the 1988 Omnibus Trade and Competitiveness Act. If the incoming Bush administration chose to use the new law's provisions in an aggressive manner, these experts feared, the world trading system would begin to unravel -- to Japan's severe detriment.

As is often the case, events turned out not quite as expected. The consumption tax did have a major impact but not in the way originally feared. True, prices rose significantly in April and May as the tax took hold. As economists generally had predicted, however, the effect on the overall consumer price level was only a fraction of the 3 percent levied. Furthermore, by year's end, the tax clearly had failed to generate self-sustaining price increases in the economy.

Instead, the tax created a highly skewed pattern of consumer spending. In the first three months of 1989, when the tax provisions were widely known but not yet implemented, consumers opened their pocketbooks to buy in advance of the tax. After April 1 they correspondingly reduced their inflation-adjusted spending. By the middle of the year the question was not whether the consumption tax induced inflation but rather would sluggish spending spell an early recession. At yearend, however, this fear, too, had subsided as expenditures rose comfortably above year-earlier levels.

In addition, the consumption tax became a highly contentious political issue in a very political year. Along with a variety of scandals affecting the ruling Liberal Democratic Party, the unpopularity of the tax played a major role in the unprecedented defeat the LDP suffered in the July upper house elections. The tax also was an issue in the even more important lower house elections this past February 18.

The JEI REPORT (ISSN 0744-6489) is published weekly except for the New Year, Memorial Day, Labor Day, Thanksgiving and Christmas holiday weeks for $40 per year by the Japan Economic Institute of America, 1000 Connecticut Avenue, N.W., Washington, D.C. 20036. Second class postage paid at Washington, D.C. POSTMASTERS: Send address changes to JEI REPORT, 1000 Connecticut Avenue, N.W., Washington, D.C. 20036.

The political uncertainty in Japan generated in part by the new tax also played a role in an unanticipated movement in the yen-dollar exchange rate: the yen dropped significantly during the year (see JEI Report No. 2B, January 12, 1990), averaging Y138=$1.00 against Y128=$1.00 in 1988. For the last half of 1989 the Japanese currency generally stayed above the Y140 level. The yen's weakness may have been a factor in an improvement in the current account surplus; by yearend the dollar-denominated imbalance was showing large drops compared to year-earlier periods, in part a consequence of some transactions being valued in cheaper yen.

Protectionist fears mounted in 1989 as Washington named Japan one of three countries under the new trade act's Super 301 provision designed to open foreign markets. However, Japan's trading partners did not erect any significant new barriers that directly affected exports in 1989. In fact, trade with the United States was, if anything, beyond initial expectations since the U.S. economy proved more robust than generally expected, with real GNP growth of 2.9 percent at the upper end of Japanese analysts' forecasts.

Government's FY 1989 Outlook in Review

A year ago last January Tokyo released its outlook for fiscal 1989, which runs from April 1, 1989 to March 31, 1990. Real GNP growth was projected to average 4 percent in FY 1989, down from the 4.9 percent the government then expected for FY 1988. (Actual GNP growth in FY 1988 came to 5.3 percent.) Domestic spending, paced by consumer purchases and plant and equipment investment, was expected to be strong enough to more than offset another year of declining net exports adjusted for inflation.

Private forecasters from banks, research organizations and elsewhere were somewhat more optimistic, expecting 4.3 percent real growth in the April 1989-March 1990 period. Moreover, they differed from the government in the details, expecting consumer spending to be less robust and investment expenditures more so. (For details, see JEI Report No. 9A, March 3, 1989.) Private forecasters agreed with their government counterparts, however, that the external sector would be a drag on the economy.

With only half the year's data compiled, the government's GNP estimate for FY 1989 already is close to realization. Even if no growth whatsoever were recorded in the last two quarters of FY 1989, growth for the year would come to 3.9 percent. The government's revised December 1989 outlook expects the economy's expansion to total 4.6 percent.

Two very recent private forecasts put the FY 1989 figure higher than does the most recent government outlook. This month Nomura Research Institute and the Japan Economic Research Center estimated 5 percent and 4.8 percent GNP growth, respectively, in FY 1989. The government figure, as well as the recent private estimates, are all larger than what the government and all but the most optimistic private forecasters initially expected. Tokyo believes, as it did last year at this time, that the external sector will pull down growth 0.7 percentage point. However, it now anticipates that consumer spending will grow only 3.2 percent rather than 4.9 percent and that private plant and equipment spending will go up 14.5 percent rather than 9.2 percent. In short, greater than expected investment will more than make up for weaker than projected consumer spending. The outcome should be higher than initially anticipated GNP growth.

Private forecasters, on balance, made the same error as the government did concerning the components of demand in FY 1989: their consensus of a year ago of a 4.6 percent increase in consumer spending was too high, and their guess of a 9.8 percent expansion in investment spending was too low. However, both estimates are closer to the probable figures than those of the government. As a result, the consensus forecast of 4.3 percent real growth probably will be closer to the mark than the government's. The consensus of private forecasters now puts growth at 4.9 percent.

In short, both government and private forecasters have underestimated the growth of GNP in FY 1989 because they were too pessimistic concerning plant and equipment spending. The greater than expected vigor with which firms have modernized and expanded capacity over the last year has led to a variety of favorable results. Higher investment demand has reduced the supply of surplus savings available for overseas capital flows. Subsequently, the demand for dollars in international currency markets has been less than it otherwise would have been, thereby somewhat counteracting the downward drift of the yen.

In addition, this unexpected investment boom has contributed directly to domestic demand. For this reason the fact that consumer spending is increasing more slowly than expected is a modest surprise. The income resulting from higher investment spending often leads to expanded consumer spending. Instead, rising corporate profits appear to be both a cause and an effect of increased plant and equipment spending, leaving consumer spending relatively unaffected.

The role of investment in the Japanese economy is interesting in part because government and private forecasters had underestimated its impact substantially in FY 1988 as well. Naturally, such history raises the possibility of a recurrence in the most recent estimates.

Outlook for FY 1990

The government prepared its economic outlook for FY 1990 in the closing days of 1989. Following past practice the figures in the outlook were incorporated into budget proposals that are now before the Diet. For the coming fiscal year Tokyo expects real economic growth to equal 4 percent, identical to last year's initial forecast (see Tables 1-3). In other ways, as well, the figures amount to a rerun of last year's. Consumer spending and plant and equipment investment are expected to provide most of the impetus for growth, with both rising substantially in excess of the projected overall growth rate. Residential construction is penciled in at a plateau following explosive growth in FY 1986 and FY 1987.

Table 1: Government's FY 1990 Economic Outlook: Real Gross National Product

(percent change)

	Actual			Estimated	Projected
	FY 1986	FY 1987	FY 1988	FY 1989	FY 1990
Real Gross National Product	2.7%	3.4%	5.3%	4.6%	4.0%
Consumer Spending	3.4	4.5	5.0	3.2	4.6
Residential Construction	11.0	25.7	5.3	0.2	0.3
Private Capital Spending	4.3	10.1	17.3	14.5	7.3

Table 2: Other Indicators

(percent change unless otherwise indicated)

	Actual			Estimated	Projected
	FY 1986	FY 1987	FY 1988	FY 1989	FY 1990
Industrial Production	-0.2%	5.9%	8.8%	5.0%	4.0%
Wholesale Prices	-9.4	-2.0	-0.7	3.5	0.6
Consumer Prices	0.0	0.5	0.8	2.7	1.6
Unemployed (in thousands)	1,710	1,700	1,500	1,450	1,450

Table 3: Japan's Balance of Payments

	Actual			Estimated	Projected
	FY 1986	FY 1987	FY 1988	FY 1989	FY 1990
Dollars (billions)					
Current Account Surplus	$94.1	$84.5	$77.3	$61.0	$56.0
Trade Surplus	101.6	94.0	95.3	81.0	78.0
Exports	211.3	233.4	267.4	276.0	293.0
Imports	109.6	139.4	172.1	195.0	215.0
Yen (trillions)					
Current Account Surplus	Y15.1	Y11.7	Y9.9	Y8.6	Y8.0
Trade Surplus	16.2	13.0	12.2	11.4	11.2

The government anticipates that both wholesale and consumer prices will be flatter in FY 1990 than they will turn out to be in FY 1989. In the current fiscal year the yen has been weaker than expected, which has tended to raise import prices and, indirectly, prices throughout the economy. The government emphasizes that its assumption of an average exchange rate of Y142.5=$1.00 for FY 1990 is just that -- an assumption rather than a forecast. Presumably, an exchange rate substantially less favorable to the yen could have modest inflationary consequences; conversely, a renewal of the yen's appreciation against the dollar could reduce the inflation rate even below the 0.6 percent rate for wholesale prices that the government currently expects over the April 1990-March 1991 period.

Both Japan's trade and current account surpluses are expected to decline in the 12 months starting in April, whether measured in yen or in dollars. The projected drop from FY 1989, however, is modest. The weak yen during the current fiscal year, which presumably will not reverse course in FY 1990, has tended to lift yen-denominated import prices and to reduce dollar-denominated export prices. The effects of these price changes have dominated the FY 1989 statistics, resulting in a J-curve short-term effect that predicts smaller surpluses from a weaker currency. In the long run import volumes tend to decline

in response to higher prices, while export volumes rise because prices are lower. In FY 1990 the long-term impact may take hold, resulting in only a modest further decline in the surplus. However, if the government's figures for the upcoming fiscal year prove accurate, the cumulative effect of several years of generally subsiding imbalances will cut the surplus by 40 to 50 percent from the peak values recorded in FY 1986. For the fifth straight year real net exports are expected to decline (see Table 4), making the external sector a drag on economic growth. If the government's figures for FY 1989 and FY 1990 turn out to be correct, the current account will decline to under 2 percent of GNP in the April 1990-March 1991 period compared to a peak value of 4.5 percent in FY 1986. (Some experts believe the 2 percent level could be reached as early as FY 1989.)

Table 4: Components of Japan's Real Economic Growth

	Total Rate	Domestic		External Component
		Private	Public	
FY 1981	3.3%	1.5%	0.5%	1.2%
FY 1982	3.2	2.6	0.1	0.5
FY 1983	3.7	1.9	0.2	1.5
FY 1984	5.1	3.7	0.2	1.3
FY 1985	4.5	4.0	-0.3	0.8
FY 1986	2.7	2.8	1.3	-1.4
FY 1987	5.4	5.9	0.4	-0.9
FY 1988	5.3	6.6	0.2	-1.5
FY 1989*	4.6	n.a.	n.a.	-0.7
FY 1990**	4.0	n.a.	n.a.	-0.5

*Calculated from the government growth estimate.
**Calculated from government outlook.

Private forecasters are, as usual, more upbeat than the government about the overall pace of economic growth in the fiscal year starting April 1. On average they expect inflation-adjusted GNP to expand at a 4.4 percent pace (see Table 5). Sumitomo Trust & Banking Co., Ltd. and the Research Institute of the National Economy, with estimates of 5.2 percent and 5 percent, respectively, are the most optimistic, just as they were last year. The most pessimistic outlook belongs to Mitsubishi Research Institute, which believes growth will be 3.6 percent. The range of 1.6 percentage points in private forecasts is slightly less than last year's when it was 1.7 points.

Private forecasters are generally in agreement with the government outlook on the components of economic growth. However, like their FY 1989 forecasts a year ago, they are more optimistic than the government about plant and equipment investment but slightly less so about consumer spending. Uncharacteristically, though, the forecasters disagree on the direction of the current account imbalance. About half believe the imbalance will fall from their FY 1989 forecasts, with the range running from $43 billion (Fuji Bank, Ltd.) to $73 billion (Japan Economic Research Center) at the high end of the half that believes it will rise. Interestingly, the two extremes both base their estimates on almost the same exchange rate forecast, Y134 and Y134.8 to the dollar, respectively.

Table 5: Summary of Private Forecasts for FY 1990

(percent change unless otherwise indicated)

Banks	Real GNP FY 1989	Real GNP FY 1990	Real Consumer Spending	Real Capital Spending	Consumer Prices	Current Account Surplus*	Y/$ Exchange Rate	Oil Prices ($/barrel)
Sumitomo Trust & Banking Co., Ltd.	5.1%	5.2%	4.9%	10.1%	2.9%	$58.4	Y145.0	$18.5
Yasuda Trust & Banking Co., Ltd.	5.0	4.7	4.2	10.1	1.7	53.9	133.0	17.5
Dai-Ichi Kangyo Bank, Ltd.	4.8	4.6	5.0	10.7	1.4	48.1	135.0	18.3
Industrial Bank of Japan, Ltd.	5.3	4.6	4.5	9.8	1.6	58.9	133.0	16.9
Taiyo Kobe Bank, Ltd.	5.0	4.6	4.3	9.1	1.6	54.5	136.0	16.3
Bank of Tokyo, Ltd.	5.0	4.5	5.0	10.0	1.5	65.0	130.0	17.7
Fuji Bank, Ltd.	4.9	4.5	5.0	8.8	1.4	43.0	134.0	17.0
Mitsui Bank, Ltd.	5.1	4.5	4.3	10.2	1.5	57.5	131.3	18.0
Tokai Bank, Ltd.	5.0	4.5	5.0	10.0	1.5	65.0	130.0	17.7
Bank of Yokohama, Ltd.	4.3	4.4	4.6	9.2	2.0	52.7	134.0	17.0
Mitsubishi Bank, Ltd.	4.6	4.4	4.6	9.3	2.3	61.9	140.0	18.7
Mitsubishi Trust & Banking Corp.	5.1	4.4	4.0	8.4	1.8	64.1	131.0	18.2
Daiwa Bank, Ltd.	5.1	4.3	4.5	9.7	1.4	52.2	135.0	17.5
Hokkaido Takushoku Bank, Ltd.	5.0	4.3	4.6	8.9	1.5	60.7	133.3	17.7
Mitsui Trust & Banking Co., Ltd.	4.7	4.3	4.2	10.2	1.8	58.5	135.0	17.4
Sumitomo Bank, Ltd.	4.5	4.3	4.5	9.3	1.5	69.2	130.0	18.0
Toyo Trust & Banking Co., Ltd.	4.9	4.1	4.6	7.3	1.6	62.0	135.0	17.0
Chuo Trust & Banking Co., Ltd.	4.8	4.0	4.3	9.5	1.6	53.1	137.0	18.1
Nippon Credit Bank, Ltd.	4.5	4.0	4.2	8.1	1.5	60.4	140.0	17.8
Insurance Companies								
Dai-Ichi Mutual Life Insurance Co.	4.9	4.5	4.4	9.6	1.3	65.0	140.0	17.0
Meiji Mutual Life Insurance Co.	4.8	4.5	4.3	9.1	1.5	57.4	135.0	18.0
Tokio Marine & Fire Insurance Co., Ltd.	5.1	4.5	4.5	9.6	1.7	59.0	137.0	17.5
Sumitomo Life Insurance Co.	4.7	4.4	4.5	9.0	1.7	68.0	132.0	17.5
Asahi Mutual Life Insurance Co.	4.8	4.2	4.3	9.3	1.4	55.7	135.0	17.0
Trading Companies								
Sumitomo Corp.	5.0	4.7	4.8	8.4	1.8	62.3	135.0	17.5
Mitsubishi Corp.	4.8	4.6	4.5	9.6	2.0	58.0	135.0	17.5
Marubeni Corp.	4.8	4.0	4.5	7.5	2.0	56.7	135.0	17.0
Research Organizations								
Research Institute of the National Economy	5.0	5.0	5.0	10.5	2.0	56.2	135.0	18.0
Japan Economic Research Center	4.8	4.9	4.4	8.4	1.3	73.0	134.8	16.5
Kangyo Kakumaru Research Institute	5.1	4.8	4.6	8.9	1.1	60.2	140.0	17.5
Kansai Economic Research Center	5.2	4.6	4.2	8.8	3.0	62.9	136.0	17.9
Sanyo Investment Research	4.9	4.6	4.7	10.8	1.9	66.5	140.5	17.5
Daiwa Securities Research Institute	5.2	4.5	5.0	8.2	1.8	62.1	136.2	17.5
Nomura Research Institute	5.0	4.5	4.8	9.5	1.8	60.5	138.0	18.0
Yamaichi Research Institute	4.6	4.5	5.1	10.1	1.9	55.5	137.0	16.3
Cosmo Research Center	4.9	4.3	4.2	9.8	1.7	51.1	135.0	18.0
Okasan Economic Research Institute	4.8	4.3	4.0	9.4	1.7	64.4	132.5	18.0
Nikko Research Center	4.6	4.0	4.3	8.0	1.7	57.0	135.0	17.0
Mitsubishi Research Institute	4.5	3.6	4.1	8.9	1.8	58.0	142.0	18.3
Average Forecast	4.9	4.4	4.5	9.3	1.7	59.2	135.5	17.6

*In billions of dollars.

Source: Toyo Keizai Tokei Geppo

Factors Affecting the Economy in FY 1990

Forecasters, both public and private, fared fairly well in fiscal 1989. While the GNP growth rate is likely to be about 0.6 percentage point above the government's estimate, that degree of accuracy is far better than in some previous years. Private forecasters did even better, with the actual FY 1989 growth figure almost certain to lie within the range of forecasts made a year ago. In part this accuracy reflects the absence of any dramatic factors exerting a strong influence one way or the other during the fiscal year. The yen, for example, has been relatively stable. Moreover, apart from the imposition of the relatively modest 3 percent consumption tax, Tokyo attempted few fiscal or monetary initiatives.

Will the FY 1990 forecasts prove equally accurate? Most of the forecasts summarized in Table 5 were made in late November or early December. Obviously, events since then and changing expectations potentially could affect how closely the economy and the forecasts match in FY 1990. The most important recent change in the Japanese economy involves a hike in interest rates. Under its new governor, Yasushi Mieno, the Bank of Japan has signaled a willingness to tighten monetary policy significantly both to nip in the bud what it believes to be incipient inflation and to strike preemptively against an apparent recent tendency of the yen to drift lower against the dollar and other major currencies. On Christmas Day BOJ raised the official discount rate half a percentage point, to 4.25 percent, the highest level in almost four years. That move came on top of an increase in May and another in October. Furthermore, not a few analysts believe the rate will go still higher after the February 18 lower house elections.

The December increase in the discount rate had a hand in confusing Japan's financial markets in January. Bond prices were sharply lower, and the Nikkei average of stock prices also fell. Normally, such twists and turns of the stock market have little effect on the economy, but some analysts have suggested a difference this time, especially in conjunction with the discount rate hikes. The events of December and January would appear to pose a threat to the twin pillars of Japan's three-year-old economic expansion -- plant and equipment investment and consumer spending.

Investment spending is, of course, interest-sensitive; a higher charge for funds implies that fewer investment projects will clear the profitability threshold. Nomura Research Institute has estimated that a 1 percentage point rise in the discount rate reduces private plant and equipment spending 1.1 percent the first year and 3.02 percent by the second year. On this basis the December hike in the discount rate would reduce plant and equipment spending by 1.5 percent in the October-December quarter of 1991. Overall GNP would drop by 0.2 percentage point during the same period and even less in earlier quarters. Taken together, Nomura's calculations suggest that the most recent hike will probably trim a mere 0.1 point off the FY 1990 growth rate. However, if the Bank of Japan raises the discount rate again in the near future, the effects would be additive. For example, if BOJ were to raise the discount rate by the same 1.75 percentage points in FY 1990 as it did in the current fiscal year, the impact eventually would reduce GNP by 0.6 point, assuming an extrapolation of Nomura's figures.

Some analysts believe the stock market potentially could have a major effect on consumer spending. As the Nikkei average and land prices have soared

in recent years, stockholders and landowners have come to feel wealthier and, in turn, have increased their spending. This effect shows up most clearly among the relatively affluent and is one reason why overall savings rates dropped in 1988 even while worker household savings rates rose, according to the latest available data. (Data for the first 10 months of 1989 show that worker household savings rates continued to rise.) Some analysts believe that high stock prices and land prices feed on each other. If so, sustained weakness in the stock market -- far beyond what has been observed to date -- could lead to a reversal of the wealth-induced drop in savings among the relatively well-off, and that implies a drop in consumer spending.

Most forecasts assume little movement during FY 1990 in the yen-dollar exchange rate. While exchange markets were relatively quiet in both 1988 and 1989, such dormancy could end abruptly. Many experts remain convinced that the long-run movement is toward a stronger yen, perhaps to the Y100=$1.00 level. In light of recent experience such a 40 percent rise in one year would be extreme but not impossible. (In FY 1986 the yen rose an average 38 percent.) Were such a hike to occur, Japanese GNP would be 1.8 percentage points lower within a year, based on an extrapolation of Nomura's figures. This prospect suggests that the Japanese economy remains highly vulnerable to exchange rate fluctuations.

The Bank of Japan's monetary policy, the drop in equity markets and the yen's possible appreciation may prove to be negative influences on the Japanese economy in FY 1990, but other factors might work the other way. For example, the yen could depreciate, giving the economy a boost equivalent to the negative influence described above. In addition, as part of the Structural Impediments Initiative talks designed to tackle the underlying macroeconomic and microeconomic causes of the huge bilateral trade imbalance, Washington has pressed Tokyo to increase its public works spending; some Japanese analysts expect that Tokyo will agree to this request. Nomura has estimated that a sustained Y1 trillion ($7.1 billion at Y140=$1.00) increase in public fixed capital formation, about a 4 percent increase, would boost GNP about 0.3 percent after a year.

More generally, the Japanese economy is entering unknown territory in FY 1990. By the reckoning of the Economic Planning Agency, Japan has had 11 economic cycles since 1951. Of these, the current expansion already is the third longest at 38 months. If the expansion continues through FY 1990, it will have lasted 51 months, longer than the 42-month "Iwato Boom" and six months shy of the famous "Izanagi Boom" that lasted from October 1965 to July 1970. Experts within the Japanese government continue to argue whether or not the Izanagi Boom met an unnatural fate at the hands of inappropriate economic policy. Not surprisingly, these experts also disagree as to whether the current expansion can go on indefinitely, especially since the Japanese economy has changed substantially during the past 20 years.

Pessimists believe that the business cycle is like a relay race, with the leading sectors changing periodically, much like relay runners passing the baton. However, like runners who drop the baton because of a slight shift in timing, the economy's expansion could be jeopardized if a sector does not take over from another at the right moment. Optimists are more likely to think of economic expansions in terms of launching a space vehicle: an initial tremendous thrust is needed to launch the rocket into space but, once there, forward motion is relatively easy to sustain.

Both examples suggest the merits of having a back-up procedure in case a runner drops the baton or a primary system fails. However, in its current expansion Japan's economy consistently has depended heavily for its growth on a single sector. Over half of the quarterly GNP growth in the past 18 months has stemmed from plant and equipment spending. Clearly, if that source fails to perform as expected, the impact on the whole economy would be substantial.

Based on current estimates, this primary system has turned out to be more powerful than anticipated in FY 1989: plant and equipment spending has soared far above initial expectations and has led Japan's economy to a near-record performance substantially above the original forecasts. The economy faces similar possibilities in FY 1990. If firms were to expand plant and equipment spending by 14.5 percent in the April 1990-March 1991 period -- the predicted rate of increase in FY 1989 -- rather than by the modest 7.3 percent expected by the government, then GNP probably would rise more than an extra percentage point based on the relationship between investment and GNP implicit in the private sector's economic forecasts. Conversely, flat investment spending would reduce the aggregate growth rate sharply compared to the published forecasts.

Already, surveys are suggesting that plant and equipment spending plans could be revised upward, again. Equipment orders, excluding ships and electric utilities, are a widely watched indicator of investment intentions. Between August and November such orders were running more than 20 percent ahead of the same period in 1988, although they dipped to a 7.2 percent year-to-year gain in December, the most recent figure available. In addition, EPA's February 1990 survey of the investment plans of big companies revealed that firms were expecting to increase their plant and equipment spending by 21 percent in FY 1989, an increase from the 17 percent hike they anticipated in November. This finding hints that the estimates in Tables 1 and 5 for plant and equipment spending may be too low. In addition, it suggests that the business sector's optimism continues to increase, with the distinct possibility that rising expectations could spill over into FY 1990 reality.

Japan's automotive industry attracts obvious interest in this regard. In late February Nihon Keizai Shimbun, the economic daily, reported that Japan's largest motor vehicle makers, Toyota Motor Corp. and Nissan Motor Co., Ltd., were planning substantial hikes in plant and equipment spending. Toyota reportedly plans a 23.1 percent increase in calendar 1990 over last year's figure; Nissan has penciled in a 53.3 percent jump for FY 1990 compared with FY 1989's outlays. Other Japanese automakers also were reported to be considering substantial increases. One motivation was said to be the growing shortage of workers, particularly in the vicinity of existing plants. This example suggests that, while the reasons could be different than in the past, investment levels could continue rising during FY 1990 in this and other important industries.

Implications for U.S.-Japan Economic Relations

Bush administration economic officials feel that the strength in plant and equipment spending in Japan could lead to an export surge, even though the short-run effect is to absorb excess Japanese savings. Apparently in response to U.S. pressure, the Ministry of International Trade and Industry reportedly is watching the investment plans of Japan's automakers and other manufacturers carefully. At times MITI has asked the companies to scale back expansion plans or scrap some capacity if new spending is planned.

Washington's concern about investment is ironic in light of what it was telling Tokyo three years ago. In 1987 Washington pressed Tokyo to energize its domestic economy. The idea was for Japan to absorb more of its own production and to increase imports. The rest, as described above, is history: the Japanese economy boomed and imports gathered speed. Washington does not appear to appreciate the fact that surplus savings in Japan have declined, since that reduction has been masked by the yen's higher value since 1985. Consequently, the flow of capital overseas has remained at almost the same rate in dollars. For the same reason the Japan-U.S. trade imbalance, while sharply lower in yen, has hardly budged in dollars. In Tokyo's view progress is substantial; in Washington's opinion, minimal.

Wall Street, which worries about whether Japanese investors will buy U.S. Treasury securities in expected amounts, feels the Japanese financial presence more than ever. American financial analysts are even paying increasing attention to Japanese monetary policy in the correct belief that it will influence Japanese investors' behavior outside their home base. Little do those on Wall Street seem to realize that, like a couple on its first date, both sides are equally nervous. Only the U.S. market is big enough to absorb the Japanese funds. If access were to be restricted or if American monetary policy turned wildly inflationary, Japanese financial institutions would have few profitable options. Should getting out prove necessary, the size of the Japanese holdings would make a quiet exit difficult.

Financial analysts on both sides of the Pacific understand their dependence on each other, as do the respective central banks. However, given that interdependence, the appropriate policy response is not necessarily clear. For example, consider the situation that faced the Bank of Japan and the Federal Reserve Board in December, when BOJ was worried about inflation in Japan and the Fed about a downturn in the U.S. economy. (West Germany and Japan were in comparable situations and acted similarly, roughly doubling the impact of their actions vis-a-vis the United States.) BOJ opted to raise interest rates and otherwise tighten money, tempting Japanese investors to keep more funds at home. To the extent this strategy worked, U.S. interest rates faced upward pressures since the supply of funds diminished in the U.S. market. However, the Fed was tempted to pursue a loose monetary strategy, with lower interest rates, in order to hold off a downturn. Had it done so vigorously at the same time BOJ was tightening policy, the flow of funds from Japan quickly could have dried up, risking turmoil in U.S. financial markets. Clearly, both BOJ and the Fed were constrained in the actions they could take; in this instance the adjustments on both sides minimized the upheaval on securities markets in the United States and Japan.

The December experience could be repeated in the near future. The forecasts summarized above suggest that the Japanese economy will remain strong; those forecasts easily could prove conservative, as they have the last three years running. As long as the U.S. economy remains healthy as well, the potential policy conflicts that confronted BOJ and the Fed in December will remain muted. However, should the U.S. economy seriously falter, the central banks of both countries could face a severe dilemma.

If the Japanese expansion continues at its current pace, BOJ will feel increasingly compelled to tighten money. The Fed would feel renewed pressure to adopt a looser U.S. policy, especially in an election year, should the U.S.

economy show signs of weakening. If pursued unilaterally, the Fed's actions would push down interest rates in the United States and tend to lower them in Japan as well. However, a BOJ move to raise Japanese rates would result in some spillover to American financial markets and tend to nudge rates up here. In other words, if the central banks acted simultaneously they would be pushing interest rates in opposite directions in both countries.

For BOJ the choice is not simply whether to help the Fed. As Japan plays a larger role in international markets, preventing inflation in Japan benefits anyone anywhere holding yen-denominated securities. In addition, rightly or wrongly, BOJ believes that low inflation is a key to continued consumer confidence in Japan. Should consumer confidence falter, economic growth would decline. If that were to happen, Washington and Tokyo would return to the situation as it existed in 1987 when Japan's economy appeared to be stagnating and Washington urged it to expand. Hence, BOJ sees little reason to reverse its tight money policy.

Interest Rates, Capital Flows and Exchange Rates

Of course, should Japan's economy remain strong and that of the United States weaken, the Fed and BOJ could both take their preferred actions provided they took care not to scare financial markets. The result would be lower interest rates here and higher ones in Japan, with both changes offset to some extent by opposite forces from the other country. The diminished interest rate gap would tend to reduce the demand for dollars on the part of Japanese investors, and thus drive down the dollar against the yen. This, in turn, would reduce the bilateral and worldwide trade imbalances of both the United States and Japan.

The BOJ-Fed policy mix described above is more likely in the coming year than it has been in the past. The longer the Japanese expansion continues, the more BOJ worries about inflation. The Federal Reserve Board is not unconcerned about inflation but has to give the possibility of an economic downturn considerable weight in its policy formulation. The Fed has indicated by its past actions that it would move quickly in the face of recessionary forces. Should the BOJ tighten -- and the Fed loosen -- their respective monetary policies, the value of the yen would rise against the dollar, as noted. For this reason, the yen's recent weakness does not necessarily point to its future direction. Since this situation presupposes a vigorous economic expansion, the shift toward domestic-led growth and away from exports might be more pronounced than shown in the government and the private forecasts summarized above.

How a combination of tighter monetary policy in Japan and a stronger yen would play in Washington remains to be seen. The United States would certainly welcome a reduction in the trade imbalance. However, Tokyo's actions would also nudge U.S. interest rates higher than they otherwise would be and risk disruption in financial markets. In addition, the dollar-denominated reduction in the trade imbalance would be small since the yen's appreciation once again would obscure the movement that would occur in the yen-denominated balance.

Prospects for Japan's Overseas Capital Flows

To the extent that economic influence flows east across the Pacific, the impact of economic developments in Japan are fairly clear through the end of FY

1990. With continued economic growth and the possibility of greater public and private demand for Japanese savings, Japan's surplus in savings is unlikely to increase significantly. Table 6 gives details of this argument. During the economic expansion that began in late FY 1986, personal savings have grown; however, the uses of savings within the household sector for housing and other investments have risen faster, resulting in a reduction in the household surplus. The corporate imbalance has widened dramatically as plant and equipment spending has surged. Despite a shrinking public-sector deficit that turned to surplus in FY 1988, spending in the previous two fiscal years by households and corporations significantly reduced the availability of funds for financing overseas deficits (excess demand by overseas users of Japanese capital). Nomura, based on a forecast that is typical of those summarized in Table 5, believes this trend has continued in FY 1989 but that it will end in FY 1990 as the aggregate overseas deficit stabilizes.

Table 6: Investment-Saving Balance

(trillions of yen)

	Actual			Estimated	Projected
	FY 1986	FY 1987	FY 1988	FY 1989	FY 1990
Household Sector	Y32.6	Y28.9	Y25.1	Y27.6	Y29.7
Corporate Sector	-2.0	-11.4	-15.4	-21.0	-25.0
Public Sector	-13.5	-3.6	2.0	3.1	3.9
Foreign Sector	-15.1	-11.7	-9.9	-8.1	-8.3
Financial Sector	-2.0	-2.2	-1.8	-1.5	-0.3

Notes: Figures for FY 1989 and FY 1990 are estimates and projections of Nomura Research Institute.

A negative figure indicates that a sector is a net user of Japanese savings. Therefore, balance of payments surpluses correspond to negative figures in the table.

Source: Nomura Research Institute

If, for the reasons outlined above, Japanese monetary policy tightens significantly vis-a-vis U.S. actions, the yen could be substantially stronger than assumed in Nomura's forecast. Such a development would tend to induce Japanese capital to stay at home, reducing the outflow in yen but tending to raise the amount as measured in dollars. In other words, the high yen scenario described above would put into action a replay of what happened to capital flows between 1985 and 1989.

In short, the flow of funds from Japan to the rest of the world depends on the Japanese economy. All of the factors mentioned above will influence that flow. A stronger yen could increase the flow as measured in dollars, even if it reduced it as measured in yen. Higher investment, whether by firms in the form of plant and equipment spending or by the government on public works, would reduce the flow. A higher personal savings rate would increase the flow. On

balance, the best guess is that changes in overseas capital movements will be modest, as indicated in Table 6, with a chance that the flow as measured in yen could be significantly smaller if the Bank of Japan and the Federal Reserve Board act to tighten and loosen money, respectively.

Conclusion

As Japan enters the fourth full fiscal year of its economic expansion, it is plowing new ground. Not for a generation has economic growth in Japan been so consistently strong for so long. As a result, forecasting the coming year involves even more than the usual amount of guesswork. As usual, Japanese forecasters in and out of government see little dramatic change. However, as Japan approaches both full employment of its labor force and full capacity of its factories, the dangers and the uncertainties of running full bore obviously increase.

The Bank of Japan understands the risks. As it wrestles with ways to offset them, BOJ necessarily will run a hazard of a different sort: attempting policy coordination with the Federal Reserve Board should the American economy weaken significantly at the same time the Japanese economy appears in danger of overheating. BOJ and the Fed could avoid these problems by, for example, carefully raising rates in Japan and reducing them in the United States, which also would have the salubrious effect of a smaller trade imbalance. However, there is little prospect that a year from now the U.S.-Japan relationship will be drained of its current tension. Reducing the trade imbalance could exacerbate other problems. Like children playing on a see-saw, Washington and Tokyo could start by learning the limitations of the instruments they are using.

For further information, contact Douglas Ostrom.

* * * * * *

The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

APPENDIX

Japan's Real Gross National Product at Constant (1980) Prices

(in billions of yen, seasonally adjusted, quarterly totals and rates of growth at annual rates)

	FY 1987	FY 1988	October-December 1988	January-March 1989	April-June 1989	July-September 1989
Gross National Product	Y318,109.2 (5.4%)	Y334,968.8 (5.3%)	Y337,203.3 (4.7%)	Y343,155.4 (7.2%)	Y340,561.8 (-3.0%)	Y350,520.9 (12.2%)
Personal Consumption Spending	176,556.3 (4.5%)	185,317.8 (5.0%)	185,932.0 (3.0%)	188,458.9 (5.5%)	186,600.8 (-3.9%)	190,316.3 (8.2%)
Private Residential Construction	19,653.9 (25.7%)	20,686.8 (5.3%)	21,241.7 (12.1%)	21,341.2 (1.9%)	20,855.0 (-8.8%)	21,340.1 (9.6%)
Private Fixed Nonresidential Investment	61,897.9 (10.1%)	72,617.1 (17.3%)	73,117.5 (13.2%)	77,820.6 (28.3%)	78,320.0 (2.6%)	84,033.5 (32.5%)
Change in Business Inventories	1,618.0 (*)	2,080.6 (*)	2,362.2 (*)	1,080.4 (*)	2,463.2 (*)	1,815.1 (*)
Government Current Expenditures	28,697.2 (-0.6%)	29,341.5 (2.2%)	29,461.4 (3.3%)	29,647.9 (2.6%)	29,650.4 (0.0%)	29,727.0 (1.0%)
Government Fixed Investment	24,335.8 (9.4%)	24,621.6 (1.2%)	24,542.9 (0.6%)	24,674.3 (2.2%)	24,540.4 (-2.2%)	24,214.0 (-5.2%)
Change in Government Inventories	46.1 (*)	-185.0 (*)	-879.0 (*)	261.2 (*)	371.8 (*)	63.4 (*)
Net External Sector	5,304.1 (-33.7%)	488.4 (-90.8%)	1,424.7 (235.3%)	-129.0 (*)	-2,239.8 (*)	-988.5 (*)
Exports of Goods and Services and Factor Income Received	55,507.1 (5.4%)	61,457.7 (10.7%)	62,093.4 (4.0%)	66,337.7 (30.3%)	65,824.7 (-3.1%)	69,636.2 (25.3%)
Imports of Goods and Services and Factor Income Paid	50,203.0 (12.4%)	60,969.3 (21.4%)	60,668.7 (2.2%)	66,466.7 (44.1%)	68,064.5 (10.0%)	70,624.7 (15.9%)

*Cannot be calculated or meaningless.

Source: Economic Planning Agency